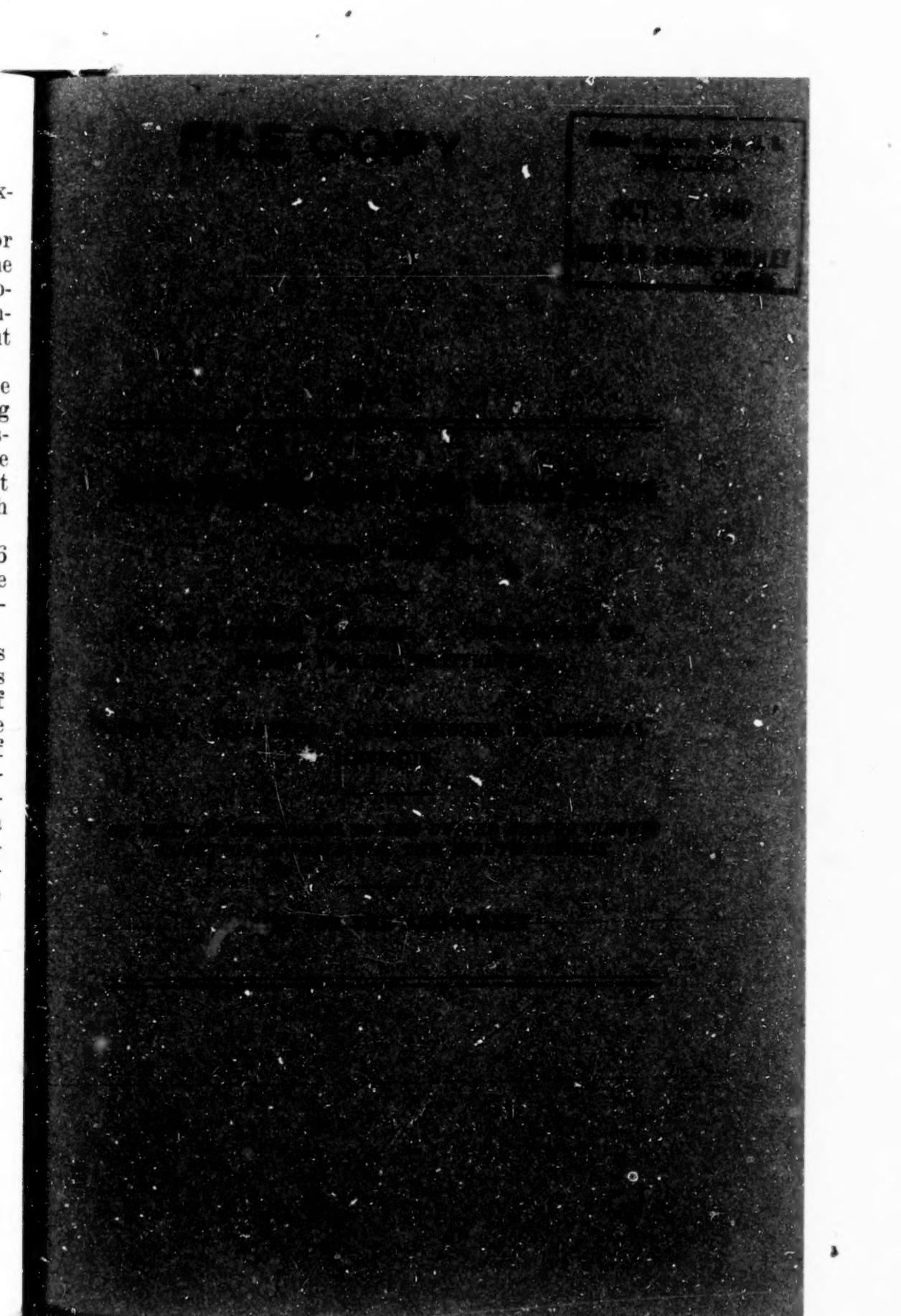
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In the Supreme Court of the United States

OCTOBER TERM, 1940

No. 8

CRANE-JOHNSON COMPANY, A CORPORATION OF NORTH DAKOTA, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 14–21) is reported in 38 B. T. A. 1355. The opinion of the Circuit Court of Appeals (R. 41–45) is reported in 105 F. (2d) 740.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered August 8, 1939. (R. 45–46.) A petition for rehearing was denied on September 15, 1939. (R. 46.) The petition for a writ of certiorari was filed December 12, 1939, and was denied

on January 15, 1940. On March 25, 1940, the Court entered an order granting the petitioner's motion for leave to file a petition for rehearing, granting the petition for rehearing, vacating the order denying certiorari, and granting the petition for a writ of certiorari. The jurisdiction of this Court is conferred by Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

The adjusted net income of the petitioner for the year 1936 was $12,032.72. As of January 1, 1936, the petitioner had a deficit of at least $21,-251.40, the origin of which does not appear. No distributions to the stockholders were made during the year. A North Dakota statute prohibits the directors of a corporation from paying dividends "except from the surplus profits arising from the business thereof". The questions presented are:

1. Whether the North Dakota statute in conjunction with petitioner's charter or certificates of stock constitutes "a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends", within the meaning of the credit provisions of Section 26 (c) (1) of the Revenue Act of 1936.

2. Whether the undistributed profits tax, as applied to petitioner, violates the Fifth Amendment to the Constitution.

3. Whether petitioner has shown that it was prohibited by state law from paying out all or a part of its adjusted net income for 1936 as dividends.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations will be found in the Appendix, *infra*, pp. 55–62.

STATEMENT

The facts as stipulated (R. 12–13) and as found by the Board of Tax Appeals (R. 14) may be summarized as follows:

The petitioner was incorporated in 1903 under the laws of North Dakota (R. 12, 14). As of January 1, 1936, it had a deficit of at least $21,251.40.[1] The records of the corporation prior to January 1, 1929, are not susceptible of analysis to show definitely whether this deficit occurred from operating losses or capital distributions in excess of earnings, or was effected by other adjustments (R. 7, 12, 14).

No dividend distributions have been made by the petitioner since March 1930, when $9,672 was distributed from surplus balance existing at that time (R. 12).

[1] The deficit shown on the books and on the balance sheet accompanying the return of income was $22,876.40, but an audit made by a firm of certified public accountants showed a deficit less than that amount by $1,625. The difference resulted from the auditor's correction of the value of treasury stock (R. 12).

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The petitioner's net income for 1936 was $13,450.76. Its adjusted net income for that year was $12,032.72 (R. 13, 14).

In its return for 1936 the petitioner claimed a credit under Section 26 (c) (1) of the Revenue Act of 1936 in the computation of the surtax on undistributed profits. The Commissioner disallowed this credit, determined a surtax of $1,707.36 on undistributed profits, and assessed a deficiency in that amount (R. 12–13). The Board of Tax Appeals sustained the Commissioner's action (R. 21–22), and the Circuit Court of Appeals affirmed (R. 45).

SUMMARY OF ARGUMENT

I

1. Section 26 (c) (1) of the Revenue Act of 1936 provides that in computing the undistributed profits tax imposed by Section 14 of the Act, a credit shall be allowed if the taxpayer corporation cannot distribute dividends "without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends." The basic issue in this case is whether a North Dakota statute prohibiting the directors of a corporation from paying dividends except from surplus profits, taken in conjunction with petitioner's charter, constitutes "a provision of a written contract executed by the corporation" within the meaning of Section 26 (c) (1).

Petitioner's argument is that its charter constitutes a written contract and that the North Dakota statute should be treated as part of that contract. The argument is unrealistic. In normal parlance, the words "a provision of a written contract executed by the corporation" neither connote nor comprehend the provisions of a state regulatory statute. In popular understanding, a "statute" is a very different thing from a "contract." A contractual restraint upon the distribution of earnings is one imposed by the voluntary act of the corporation; a statutory restraint is one imposed by the state legislature without any voluntary act by the corporation. The two restraints are of different character and in common speech they are always differently characterized. Elementary principles of statutory construction, therefore, preclude the contention that when Congress used the words "a provision of a written contract executed by the corporation" it intended thereby to embrace the corporation laws of the various states. Had it had this intention, it would have been a simple matter for it to have said so.

The same conclusion follows if the language of Section 26 (c) (1) is examined literally. The credit is allowed only in the case of a contract "executed" by the corporation. This plainly means a contract which the corporation has signed. Corporate charters are executed by individuals desiring to incorporate and by the issuance to them

of a certificate of incorporation by the state. The corporation itself has no existence until the certificate is issued and it obviously does not execute the articles of incorporation.

Moreover, even though a corporate charter be deemed to be a written contract executed by the corporation, a state law restricting the payment of dividends cannot properly be deemed to be a "provision" of that contract. The most obvious and rational meaning of the words "a provision of a written contract" is a provision expressly written into the contract and not one that is implied. A state law is not expressly written into a corporate charter; at most, the corporation by accepting the charter enters into an implied agreement that it will abide by the law. It would be a strained and unnatural interpretation to construe such an implied agreement as making a state law a provision of a written contract.

There are practical considerations, too, which strongly indicate that Congress could not have intended Section 26 (c) (1) to apply to state laws restricting the payment of dividends. It is relatively easy for the Bureau of Internal Revenue to determine whether a corporation has signed what is commonly thought of as a written contract prohibiting dividend payments, but if Section 26 (c) (1) is construed as referring to state laws prohibiting the payment of dividends, the Bureau will be required to determine in every case what the state

law is, how it is administered in practice, and whether the particular corporation was so situated that a payment of dividends by it would have violated the state law. This would place an intolerable burden upon the Bureau and one which Congress could scarcely have wished to impose.

Remaining doubt, if any, as to the meaning of Section 26 (c) (1) is dispelled by the legislative history of its enactment. This shows that the failure of Congress to afford relief to corporations restrained by state laws from paying dividends was deliberate. The attention of Congress was repeatedly called to the situation of such corporations. The House bill contained a provision which gave them some relief, but that provision was stricken out. The situation of deficit corporations was one of the motivating reasons for the changes made in the undistributed profits tax by the Revenue Act of 1938.

Treasury regulations and Bureau of Internal Revenue rulings have consistently held that a charter is not a written contract executed by the corporation within the meaning of Section 26 (c) (1). This administrative construction should not be overturned in view of the practical difficulties which would flow from any other interpretation.

2. Petitioner's alternative argument, not raised before the Board or properly presented to the court below, that its stock certificates were written con-

tracts executed by it and that the North Dakota statute was a part of such contracts, is untenable. Although stock certificates containing express restrictions against dividend payments would come under Section 26 (c) (1), a state law restricting dividend payments, which is at best an implied provision of the stock certificates, does not satisfy the requirements of the section.

II

There is no merit in petitioner's argument that if it is not entitled to credit under Section 26 (c) (1), the undistributed profits tax, as applied to it, violates the Fifth Amendment. The only constitutional question raised in the petition for certiorari was one of arbitrary and unreasonable classification and consequently that is the only issue under the Fifth Amendment discussed in this brief.

Congress was clearly justified in drawing a distinction between corporations having undistributed net income and corporations not having undistributed net income. Before enactment of the undistributed profits tax, corporate income which was distributed was taxable to the stockholders, whereas corporate income which was undistributed escaped such taxation. This not only created an inequality in the tax burden imposed upon the earnings of different corporations, but also provided a means for stockholders to avoid surtaxes on their individual incomes. Moreover, there was in-

equality in the tax upon the earnings of corporations and of unincorporated enterprises, such as partnerships, since partnership income was taxable to the partners whether distributed or not. The Congressional purpose to remove these inequalities and to eliminate surtax avoidance constitutes ample justification for the different treatment accorded distributed and undistributed income.

The fact that Congress granted a credit to corporations under certain types of contractual restraints against the payment of dividends and denied the credit to corporations under other types of restraints, furnishes no ground for attack under the Fifth Amendment. Deductions and credits are a matter of legislative grace; consequently, the allowance of one deduction and the failure to grant another cannot be said to violate the due process clause. Moreover, there was clearly a rational basis for the distinction drawn by Congress. As pointed out, it is a comparatively easy matter for the Bureau of Internal Revenue to ascertain whether a corporation has executed a written contract which expressly prohibits it from paying dividends, but it would impose an intolerable administrative burden on the Bureau if it were required to determine whether a corporation was prevented from distributing its earnings by virtue of state law. This practical consideration alone warrants the classification made by Congress.

III

The decision below must be affirmed even should the court reject the foregoing arguments, because the petitioner has not sustained the burden of proving that it was in fact prohibited by state law from distributing its adjusted net income for 1936.

ARGUMENT

INTRODUCTORY

This case presents the question of the proper construction of a portion of the undistributed profits tax law enacted by Congress as part of the Revenue Act of 1936. This Act, while continuing the normal tax upon corporate income, imposed a surtax at graduated rates upon such of the corporate profits as were not distributed during the tax year by way of dividends. The major purposes of the surtax were to equalize the tax burden on all corporate income, whether distributed to or withheld from the stockholders, and to prevent the avoidance of surtax by individual stockholders through the impounding of corporate profits in surplus. See H. Rep. No. 2475, 74th Cong., 2d Sess., pp. 1–3.

The formula for computation of the tax is set forth in Section 14, *infra,* pp. 55–56. The basis of the tax is that portion of the "undistributed net income" of the corporation which is in excess of specified percentages of the "adjusted net income". "Adjusted net income" is defined as net income

less certain specified credits, and "undistributed net income" is defined as the adjusted net income less the amount of the dividends paid during the tax year and less the credits provided in Section 26 (c).

Section 26 (c) is the crux of the present controversy. It was designed to afford relief from the surtax in certain narrowly limited situations to corporations which were under contractual restraint against the distribution of their profits. The pertinent provisions of the section follow:

> SEC. 26. CREDITS OF CORPORATIONS.
>
> In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—
>
> * * * * *
>
> (c) *Contracts Restricting Payment of Dividends.*—
>
> (1) *Prohibition on Payment of Dividends.*—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. * * *
>
> (2) *Disposition of Profits of Taxable Year.*—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision ex-

pressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. * * *

(3) *Double Credit Not Allowed.*—If both paragraph (1) and paragraph (2) apply, the one of such paragraphs which allows the greater credit shall be applied; and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

The narrow scope of the relief afforded by Section 26 (c) (1) is apparent. It does not apply to a corporation which is prevented from distributing income pursuant to the terms of an oral contract. See *Northwest Steel Rolling Mills, Inc.* v. *Commissioner,* 110 F. (2d) 286, 288 (C. C. A. 9th). It does not apply to a corporation which is prevented from distributing income pursuant to a contract entered into after May 1, 1936. It does not apply to a corporation which is prevented from distributing income pursuant to a contractual obligation, such as that embodied in many mortgage indentures and preferred stock certificates, requiring it to maintain its net assets at a certain ratio to its liabilities, or to maintain its net tangible assets at a certain amount, since such a provision does not deal "expressly" with the payment of dividends. Treasury Regulations 94, Article 26–2 (b), *infra*

pp. 61–62; see Note (1936) 50 Harv. L. Rev. 332, 340. In other words, no restraint upon the distribution of profits, whether the restraint be imposed by law, by contract or by sound business policy, furnishes ground for relief except a restraint expressly imposed by "a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends."

Petitioner seeks to bring itself within the scope of Section 26 (c) (1) by urging (1) that since it had a deficit in 1936 of a larger amount than its earnings for that year, it was prohibited by a North Dakota statute from distributing any dividends;[2] and (2) that the North Dakota statute constitutes a part of the charter of the corporation and therefore should be treated as "a provision of a written contract executed by the corporation prior to May 1, 1936" within the meaning of Section 26 (c) (1).[3]

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[2] Section 4543 of the North Dakota Compiled Laws, 1913–1925, *infra*, pp. 58–59, prohibits the directors of a corporation from paying dividends "except from the surplus profits arising from the business thereof * * *." Section 4544, *infra*, pp. 59–60, imposes a civil liability on directors who violate this provision. Similar provisions were in effect in 1903 when petitioner was incorporated. See Sections 2891–2892, North Dakota Revised Code (1899).

[3] In this Court petitioner makes the alternative argument that its stock certificates, in conjunction with the state statute, likewise constitute a written contract executed by the corporation. This argument was made for the first time in an unsuccessful petition for rehearing in the court below, except for an oblique reference thereto in petitioner's reply brief (pp. 5–6), and for reasons pointed out below (pp. 35–37, *infra*), we believe that it is without merit.

Petitioner further contends that if the statute should be construed as denying the relief claimed, the surtax is violative of the Fifth Amendment.

The Government's position is that a statutory provision restricting dividend payments can never constitute a provision of a written contract within the contemplation of Section 26 (c), that the statute, so construed, is clearly constitutional, and that, in any event, petitioner has failed to prove that it was prohibited by state law from distributing its 1936 profits.

I

A STATUTORY PROVISION RESTRICTING DIVIDEND PAYMENTS DOES NOT CONSTITUTE "A PROVISION OF A WRITTEN CONTRACT EXECUTED BY THE CORPORATION" WITHIN THE MEANING OF SECTION 26 (c) (1)

1. The holding of the court below that a statutory provision restricting the payment of dividends does not constitute "a provision of a written contract executed by the corporation" within the meaning of Section 26 (c) (1) is, we believe, clearly correct. The decision is in accord with *Bastian Bros. Co.* v. *McGowan,* 32 F. Supp. 93 (W. D. N. Y.), affirmed per curiam (C. C. A. 2d), July 11, 1940, 1940 C. C. H. Vol. 4, par. 9581; *Utah Hotel Co.* v. *Hinckley* (D. Utah), decided Jan. 29, 1940, found in 1940 C. C. H., Vol. 4, par. 9342, and with the consistent

rulings of the Board of Tax Appeals.[4] *Northwest Steel Rolling Mills, Inc.* v. *Commissioner,* 110 F. (2d) 286 (C. C. A. 9th), is, however, in conflict with the decision below. A petition for a writ of certiorari in the *Northwest Steel* case has been filed, No. 121, present Term.

Petitioner takes a syllogistic approach to the case. Relying upon such decisions of this Court as *Dartmouth College* v. *Woodward,* 4 Wheat. 518, it advances as its major premise that the charter of a corporation is a written contract. Its minor premise is that a state statute regulating the corporation becomes a part of the charter and therefore the provisions of the statute must be deemed to be provisions of the written contract. The conclusions drawn from these premises is that petitioner is entitled to the relief provided by Section 26 (c) (1).

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[4] See *Cooperative Publishing Co.* v. *Commissioner,* 40 B. T. A. 465, and the unreported memorandum opinions in the following cases: *McBrides, Inc.* v. *Commissioner,* decided June 20, 1939; *Stein Wholesale Dry Goods Co.* v. *Commissioner,* decided January 8, 1940; *Border Queen Kitchen Cabinet Co.* v. *Commissioner,* decided January 8, 1940; *Saginaw Timber Co.* v. *Commissioner,* decided January 18, 1940; *American National Realty Co.* v. *Commissioner,* decided January 31, 1940; *Ingersoll Amusement Co.* v. *Commissioner,* decided January 31, 1940; *Clovis Hotel Co.* v. *Commissioner,* decided February 7, 1940; *Thompson Land and Livestock Co.* v. *Commissioner,* decided February 9, 1940; *Forest T. Ellis* v. *Commissioner,* decided February 9, 1940.

We challenge the validity both of the approach and of the syllogism. The question here is simply one of the intent of Congress in enacting Section 26 (c) (1); to ascertain this intent, resort should not be had to syllogistic reasoning but to "the plain, obvious and rational meaning" of the words used in the statute. *Lynch* v. *Alworth-Stephens Co.*, 267 U. S. 364, 370; *Old Colony R. Co.* v. *Commissioner*, 284, U. S. 552, 560, and cases cited.[5] And the words employed by Congress are presumed to have been used "in their known and ordinary signification." *Levy's Lessee* v. *McCartee*, 6 Pet. 102, 110; *Old Colony R. Co.* v. *Commissioner, supra.*

Here the words used are "a provision of a written contract executed by the corporation". Certainly in normal parlance those words neither connote nor comprehend the provisions of a state regulatory statute. In popular understanding, a "statute" is a very different thing from a "contract"; each term has its own accepted meaning and neither term includes the other. A contractual restraint upon the distribution of earnings is one imposed by the voluntary act of the corporation; a statutory restraint is one imposed by the state legislature without any voluntary act by the corporation. The two restraints are of different character and in common speech they are always differently

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[5] Accord: *Woolford Realty Co.* v. *Rose*, 286 U. S. 319; *Old Colony Trust Co.* v. *Commissioner*, 301 U. S. 379; *Magnano Co.* v. *Hamilton*, 292 U. S. 40.

characterized.[6] In these circumstances, elementary principles of statutory construction preclude the contention that when Congress used the words "a provision of a written contract executed by the corporation", it intended thereby to embrace the corporation laws of the various states. As the district court pointed out in *Bastian Bros.* v. *McGowan, supra,* if Congress had meant to include statutory as well as contractual restraints within the scope of Section 26 (c) (1), it would have a been a simple matter for it to have said so. Its failure to say so shows that it had no such intention. Cf. *Kessler* v. *Strecker,* 307 U. S. 22, 29.

The same result follows if we approach the question, as petitioner would have us do, by literal examination of the language employed in Section 26 (c) (1). We do not deny that, for purposes of the "contract clause" of the Constitution, a charter is held to be a contract between the state and the corporation or its stockholders. *Dartmouth College* v. *Woodward,* 4 Wheat. 518; *Home Bldg. & L. Assn.* v. *Blaisdell,* 290 U. S. 398; *The Binghamton Bridge,* 3 Wall. 51; *Jefferson Branch Bank*

[6] For example, the witnesses who appeared before the Congressional committees consistently drew a distinction between contractual restraints upon the distribution of earnings and similar restrictions imposed by requirement of law. See, e. g., Hearings Before House Committee on Ways and Means, 74th Cong., 2d Sess., on the Revenue Act of 1936, pp. 807, 836, 846; Hearings Before Senate Committee on Finance, 74th Cong., 2d Sess., on H. R. 12395, pp. 111, 122, 245, 269, 285, 291, 295.

v. *Skelly,* 1 Black 436; *Personal Industrial Bankers* v. *Citizens Budget Co.,* 80 F. (2d) 327, 328 (C. C. A. 6th). Nor do we deny that laws which exist at the time of the making of a contract and which affect its validity, construction, discharge, or enforcement enter into and form a part of the contract as though they were incorporated in its terms. *Home Bldg. & L. Assn.* v. *Blaisdell, supra; Farmers Bank* v. *Federal Reserve Bank,* 262 U. S. 649. But the language of Section 26 (c) (1) provides at least three barriers to proceeding from these premises to the conclusion that the North Dakota statute here involved, taken in conjunction with petitioner's charter, is "a provision of a written contract executed by the corporation".

In the first place, a corporate charter is not a contract "executed" by the corporation. The ordinary meaning of the word "executed," when used with reference to a written instrument, is "signed" or "signed, sealed and delivered" (*Bouvier's Law Dictionary,* (Rawle's 3rd Revision) Vol. I, p. 1111; *Words and Phrases* (1st series), Vol. III, p. 2558; *Id.* (2nd series) Vol. II, pp. 378–379); as pointed out above, words employed in a taxing statute, as in other statutes, are to be given their common or ordinary meaning. See cases cited, p. 16, *supra.* It seems clear, therefore, that Section 26 (c) (1) applies only to a written contract which the corporation has signed. Corporate charters are secured through the filing of articles

of incorporation by individuals desiring to incorporate and by the issuance of a certificate of incorporation by the state. The corporation itself has no existence until the certificate is issued, and it obviously does not execute the articles of incorporation. The majority of the court in the *Northwest Steel* case thought it sufficient that the corporation became bound by the acts of the incorporators on the theory of a novation, ratification or continuing offer. But, as pointed out by Judge Haney in his dissenting opinion in that case, this construction makes the word "executed" superfluous. It is an elementary rule of statutory construction that words used in a statute are not to be treated as surplusage where they may reasonably be given effect. *Platt* v. *Union Pacific R. R. Co.*, 99 U.S. 48; *McDonald* v. *Thompson*, 305 U.S. 263. It follows that a charter does not constitute a written contract executed by the corporation within the meaning of Section 26 (c) (1). See Note (1936) 50 Harv. L. Rev. 332, 340; cf. Note (1936) 36 Col. L. Rev. 1321, 1343.

In the second place, even though a corporate charter be deemed to be a written contract executed by the corporation, a state law restricting the payment of dividends cannot properly be deemed to be a "provision" of that contract within the meaning of Section 26 (c) (1). The most obvious and rational meaning of the words "a provision of a written contract" is a provision ex-

pressly written into the contract and not one that is implied. A state law, of course, is not expressly written into corporate charters; at most, the corporation, by accepting the charter, enters into an implied agreement that it will abide by the law. It would be a strained and unnatural interpretation to construe such an implied agreement as making the state law a provision of a written contract.

In the third place, the particular state statute involved in this case imposes a restriction against the payment of dividends upon the directors of the corporation, but not upon the corporation itself. While we believe it clear that petitioner could not maintain its position even though the prohibition operated directly upon the corporation, its position is even more untenable where, as here, maintenance of that position depends upon establishing the proposition that in accepting the charter the corporation undertakes a contractual obligation that its directors will not pay dividends except from surplus profits.

Thus, whether we approach the question of statutory construction realistically, by ascertaining the plain, obvious, and rational meaning of the language employed in Section 26 (c) (1), or whether we approach it legalistically, by ascertaining the literal meaning of the language, we arrive at precisely the same result. And the conclusion thus reached is supported by consideration of the provisions of Section 26 (c) (2) which

are in *pari materia* with those of Section 26 (c) (1). Section 26 (c) (2) provides for a credit equal to such of the earnings of the taxable year as are required "by a provision of a written contract executed by the corporation prior to May 1, 1936," to be paid in discharge of a debt or to be irrevocably set aside for the discharge of a debt. Since, so far as we have been able to ascertain, no state imposes as a requirement of law that corporate debts shall be discharged out of earnings, the words "a provision of a written contract executed by the corporation," as used in Section 26 (c) (2), must obviously refer only to voluntary corporate undertakings. The same words, as used in the cognate provisions of Section 26 (c) (1), should, of course, be similarly construed in the absence of any compelling reasons to the contrary.

There are practical considerations, too, which strongly indicate that Congress could not have intended Section 26 (c) (1) to apply to state laws restricting the payment of dividends. These laws are extremely varied and state courts construing similar provisions construe them differently. It would serve no useful purpose to enumerate all of the differences in this brief, but it may be pointed out that even under similar statutes the state courts differ in their treatment of appreciation in the value of assets, depreciation and depletion, good will and many other items. Many of the differences are pointed out in a series of articles en-

Remaining doubt, if any, as to the meaning of Section 26 (c) (1) is resolved by the legislative history of its enactment. The bill which, as enacted, became the Revenue Act of 1936, contained, in the form in which it was reported to and passed by the House, three distinct provisions designed to relieve corporations which for various reasons could not or should not pay dividends. Section 14 (a) provided that if the accumulated earnings and profits of the corporation as of the close of the taxable year (computed without diminution by reason of the distribution during the taxable year of earnings and profits, or by reason of the taxes imposed by Title I of the Act) were less than the adjusted net income, the tax should be computed in a different manner. This provision was intended to relieve corporations having a deficit. Section 15 was designed for the relief of corporations under contractual restraint against the payment of dividends, and Section 16 was designed for the relief of corporations having outstanding indebtedness. H. R. 12395, 74th Cong., 2d Sess., Secs. 14, 15, and 16.

In explanation of those provisions the Committee on Ways and Means stated (H. Rep. No. 2475, 74th Cong., 2d Sess., pp. 8–9):

EXCEPTIONS FROM GENERAL PLAN.

> It has been recognized that in certain cases corporations cannot pay out dividends or that sound policy demands the nonpay-

ment of dividends. Therefore, in certain cases, a flat rate of tax is imposed on corporate incomes, or parts thereof, in lieu of the undistributed profits tax proposed in the general case.

Deficits.—For example, section 14 of the bill provides that corporations with a deficit shall pay a tax of 22½ percent on the amount of earnings necessary to make up this deficit and only come under the new plan in respect to earnings in excess of this deficit, and in excess of the tax paid at the 22½ percent rate. This rule is more accurately stated in the section.

Contracts not to pay dividends.—In section 15 a similar treatment is accorded in respect to that part of corporate net income that cannot be paid out in dividends without violating a written contract in existence prior to March 3, 1936.

Debts.—In section 16 similar relief is given in case of certain debts which are in excess of the accumulated earnings and profits.

It is also provided that sections 14, 15, and 16 noted above shall not operate to increase the tax which would be payable without the application of such sections. A corporation, however, cannot use more than one of the relief provisions just cited but must use the one which will result in the smallest tax.

The Senate Committee on Finance substituted for the graduated undistributed profits tax provided for in the House bill, a flat surtax of 7%

on undistributed profits. It also struck out Sections 14, 15, and 16 of the House bill, but in Section 26 (c) (1) retained the principle of Section 15 of that bill affording relief to corporations under contractual restraint against the payment of dividends.

In explanation of these changes the Committee stated in its report (S. Rep. No. 2156, 74th Cong., 2d Sess., pp. 12–13, 15):

SURTAX ON UNDISTRIBUTED PROFITS

Section 14 of the committee bill imposes a surtax of 7 percent upon the amount of the undistributed net income of corporations. This, together with the normal tax on corporations, is a complete substitution for the undistributed-profits tax provision of the House bill. Instead of having a graduated undistributed-profits tax like the House bill with rates ranging as high as 42.5 percent, your committee has adopted a flat rate of 7 percent. *By this moderate rate your committee has eliminated most of the complicated relief provisions in the House bill relating to debt and deficit corporations. However, the principle of the House bill affording relief to corporations which are unable to pay dividends because of express prohibitions in contracts entered into prior to March 3, 1936, have been retained for the purpose of the 7-percent undistributed-profits tax.*

The term "undistributed net income" is defined in the bill to mean the adjusted net

income minus (1) dividends paid during the taxable year, and (2) the amount of the adjusted net income which the corporation is prohibited by contract as defined in section 26 (c) from paying as dividends during the taxable year. The adjusted net income consists of the net income of the corporation reduced by the following:

(1) The normal tax on corporations imposed by section 13;

(2) Interest on United States and Government obligations;

(3) The amount allowed as a credit to a bank holding company affiliate under section 26 (d).

* * * * *

SECTION 26. CREDITS OF CORPORATIONS.

This section sets forth certain credits allowed to corporations in computing the various taxes imposed under title I. In general, they are as follows:

* * * * *

(3) Contracts not to pay dividends: This credit is in principle similar to a relief provision allowed in the House bill for the purpose of the undistributed-profits tax imposed by that bill. It is allowed as a credit in computing undistributed net income for the purpose of the surtax on undistributed profits imposed by section 14 and in computing retained net income for the purpose of the tax imposed by section 102. [Italics supplied.]

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An amendment to Section 26 (c) on the floor of the Senate restored the credit allowed to corporations under contractual obligation to pay indebtedness which had been contained in Section 16 of the House bill. Section 26 (c) (2); 80 Cong. Rec., Part 8, 74th Cong., 2d Sess., pp. 8790–8791, 9071. A graduated rate was also substituted for the flat surtax rate which the Senate Finance Committee had recommended. But no provision for the relief of deficit corporations analogous to Section 14 of the House bill was adopted. See H. Conference Rep. No. 3068, 74th Cong., 2d Sess., pp. 2–4. See also 80 Cong. Rec., Part 8, *supra*, p. 9071.

By a change in the definition of a dividend (see Section 115 (a) of the Revenue Act of 1936, *infra*, p. 58), the bill as passed permitted a dividends-paid credit to deficit corporations which actually distributed current earnings (see Section 27 of the Revenue Act of 1936), but none was allowed to deficit corporations which did not distribute.[7]

[7] Section 115 (a) defines "dividend" as including any distribution "out of the earnings or profits of the taxable year" and obviously includes distributions made by deficit corporations having current earnings. Under this section, contrary to the implication of the statements made on pp. 39–40 of petitioner's brief, any distributions made by the petitioner during the tax year would have been taxable to its stockholders and petitioner would have been entitled to a dividends-paid credit for such distributions. *Hadden* v. *Commissioner*, 49 F. (2d) 709 (C. C. A. 2d), and *Kinnear* v.

Thus the failure of Congress to provide specifically for the allowance of a credit to corporations which had deficits and were therefore prevented by state law from paying out dividends appears to have been deliberate.[8] Section 14 of the House bill might have given them relief, but the Act as finally passed did not. It appears, moreover, that the purpose of the Senate in making the change was to eliminate the necessity of determining when there was a deficit, for, in explaining Section 115 (a), the Committee on Finance said (S. Rep. No. 2156, *supra*, p. 18):

> SECTION 115 (a). DIVIDENDS OUT OF CURRENT EARNINGS
>
> In order to enable corporations without regard to deficits existing at the beginning of the taxable year to obtain the benefit of the dividends paid credit for the purposes of the undistributed profits surtax, section 115 (a) changes the definition of a dividend so as to include distributions out of the earnings or profits of the current taxable year.

Commissioner, 36 B. T. A. 153, cited by petitioner (p. 39) arose under an earlier statute which defined the term "dividends" differently.

[8] In the hearings before both committees of Congress, attention was repeatedly called to the situation of such companies. Hearings before the House Committee on Ways and Means, 74th Cong., 2d Sess., on the Revenue Act of 1936, pp. 101–102, 836–837, 842, 846–847; Hearings before the Senate Committee on Finance, 74th Cong., 2d Sess., on H. R. 12395, pp. 234, 261–262, 269, 282, 417.

> The amendment simplifies the determination by providing that distributions during the year, not exceeding in amount the current earnings, are dividends constituting taxable income to the shareholder and a dividends paid credit to the corporation. As respects such dividends the complicated determination of accumulated earnings or profits is rendered unnecessary.

It should also be noted that Senator Walsh, a member of the Senate Finance Committee, stated on the floor of the Senate that the bill did not afford relief to corporations which were prevented by state law from declaring dividends except from surplus. He stated (80 Cong. Rec., Part 8, *supra*, p. 9058):

> Again, the laws of 36 States prohibit corporations chartered by them from making a dividend distribution if their capital is impaired. Under the proposed undistributed-profits tax, corporations affected by these provisions would be heavily penalized by the Federal tax for keeping within the law. The House bill taxes these corporations a flat rate on their net income of 22½ percent, regardless of their dividend policy.

The petitioner quotes (Br. 37) an excerpt from the minority views of Senators Walsh and George (80 Cong. Rec., Part 10, 74th Cong., 2d Sess., p. 10164), and suggests that apparently Senator Walsh, subsequent to the above-quoted statement on the floor of the Senate, had been told that he

was wrong in thinking that no relief was afforded to corporations which were prevented by state law from declaring dividends except from surplus. The excerpt is as follows:

> The defenders of the bill in the form which it has now taken contend that by sundry exemptions and modifications the smallest corporations are spared the full force of the new tax, as well as helped by the lowering of the rates on the normal corporation income tax; that the banks and insurance companies are entirely excluded; *and that in some instances corporations under contract not to pay dividends, and forbidden by law to do so, are permitted without extra penalty to apply a percentage of their earnings to reserves.* [Italics supplied.]

It will be noted that in the italicized portion of this excerpt, Senators Walsh and George did not state that corporations forbidden by state law to pay dividends would be entitled to a credit, but stated merely that in some instances they would be permitted, without extra penalty, "to apply a percentage of their earnings to reserves." The statement apparently refers to the provisions of Section 14 (c) of the Act, which provides that corporations having an adjusted net income of less than $50,000 are entitled to a specific credit, which has the effect of exempting a percentage of their earnings from the higher surtax rates imposed by Section 14 (b) and substitutes therefor a tax at 7 percent. Under this

section, small corporations are permitted to apply a percentage of their earnings to reserves and to pay a combined normal and undistributed tax thereon of only 15 percent, which is but slightly greater than the 13¾ percent normal tax imposed by the 1934 Act.

That Senators Walsh and George were not of the opinion that the Act provided relief to all corporations prevented by state law from declaring dividends is clearly shown by the statement made by them several paragraphs after the one quoted by the petitioner (80 Cong. Rec., Part 10, *supra*, p. 10164). That statement is as follows:

> * * * the following business concerns are undoubtedly discriminated against:
>
> * * * * *
>
> 3. Those prohibited by State laws from making dividend distribution if their capital is thereby impaired. Thirty-six States have such laws prohibiting directors from declaring dividends under such circumstances.

It should also be noted that when the bill which subsequently became the Revenue Act of 1938 (c. 289, 52 Stat. 447) was reported to the House, the Committee on Ways and Means stated that one of the principal objections to the surtax on undistributed profits imposed by the 1936 Act was that it was unfair to corporations with impaired capital which under state law could not legally declare dividends. It was for this reason, among others, that the undistributed profits tax was substantially

modified in the 1938 Act. See H. Rep. No. 1860, 75th Cong., 3d Sess., pp. 3–4. No provision analogous to Section 26 (c) (1) appears in the 1938 Act but certain relief for deficit corporations was afforded by the consent dividends credit provided for in Section 28. With reference to that section the Committee made the following statement (H. Rep. No. 1860, *supra,* p. 24):

> SECTION 28. CONSENT DIVIDENDS CREDIT
>
> One of the principal objections which has been urged to any form of corporation tax measured by undistributed profits has always been that many corporations, for a variety of reasons, find it difficult, if not impossible, in certain situations to declare dividends in cash or scrip or to distribute taxable stock dividends. Section 28 of the bill is intended to provide a method whereby such a corporation, with the cooperation of its shareholders, may obtain the tax benefits incident to actual distribution without violation of any contractual commitment or any rule of law which might prevent it, in whole or in part, from distributing its earnings and without depriving the Government of the revenue which would flow from the receipt of dividends by the shareholders.

Thus the legislative history of the Act supports the view that the failure of Congress to provide specifically for the relief of deficit corporations was deliberate and that it did not intend Section 26 (c) (1) to cover this situation. This, too, has been the consistent administrative interpretation.

In Article 26–2 of Regulations 94, *infra*, p. 60, promulgated under the 1936 Act, the Bureau of Internal Revenue ruled that the charter of a corporation does not constitute a written contract executed by the corporation within the meaning of Section 26 (c). See also T. D. 4674, XV–2 Cum. Bull. 53, 58 (1936). And in I. T. 3016, XV–2 Cum. Bull. 73 (1936), it was specifically held that a corporation which was restricted by state law from paying dividends while its capital remained impaired was not entitled to the relief afforded by Section 26 (c) (1). This administrative construction should not be disturbed except for weighty reasons. *Koshland* v. *Helvering*, 298 U. S. 441, 445; *Brewster* v. *Gage*, 280 U. S. 327; *Maryland Casualty Co.* v. *United States*, 251 U. S. 342; *Fawcus Machine Co.* v. *United States*, 282 U. S. 375; *National Lead Co.* v. *United States*, 252 U. S. 140; see also *Bowen* v. *Johnston*, 306 U. S. 19; *Armstrong Co.* v. *Nu-Enamel Corp.*, 305 U. S. 315. Particularly is this true where overturning the administrative construction would create great practical difficulties in the operation of the statute. See *Woolford Realty Co.* v. *Rose*, 286 U. S. 319.

Finally, the statute here involved concerns a deduction or credit. Deductions are allowed as a matter of legislative grace and provisions granting them are to be strictly construed. *White* v. *United States*, 305 U. S. 281; *New Colonial Ice Co.* v. *Helvering*, 292 U. S. 435; *Deputy* v. *duPont*, 308 U. S. 488; *Helvering* v. *Ind. Life Ins. Co.*, 292 U. S. 371;

Helvering v. *Inter-Mountain Life Insurance Co.*, 294 U. S. 686. The taxpayer invokes the rule that in construing a statute doubts are to be resolved in favor of the taxpayer, citing *Hassett* v. *Welch*, 303 U. S. 303. But that rule has no application to provisions granting deductions. *Helvering* v. *Inter-Mountain Life Insurance Co., supra.*[9]

2. Petitioner's alternative argument, that its stock certificates are written contracts with its stockholders executed by it and that the North Dakota statute prohibiting the payment of dividends constitutes a provision of those contracts,

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[9] The petitioner argues that Section 26 (c) (1) is a relief provision which should be construed liberally, citing *Old Colony Trust Co.* v. *Commissioner*, 301 U. S. 379; *Bonwit Teller & Co.* v. *United States*, 283 U. S. 258, 263; *Kelly-Springfield Tire Co.* v. *United States*, 81 F. (2d) 533 (C. C. A. 3d); *Johnston* v. *Commissioner*, 33 B. T. A. 551; and *Standifer Construction Corp.* v. *Commissioner*, 4 B. T. A. 525. The last two cases cited involved not deductions but provisions relating to the method of reporting income. The *Bonwit Teller* case, too, did not involve a deduction but a provision of a tax law giving taxpayers an opportunity to secure refunds of barred overpayments. Provisions relating to deductions have been regarded only in rare instances as relief provisions to be construed liberally in favor of the taxpayer. The *Old Colony Trust Co.* case related to a deduction for charitable contributions, and it was held that since the deduction was granted from motives of public policy, the statute allowing it was to be liberally construed. The *Kelly-Springfield Tire Co.* case concerned a provision allowing a deduction for amortization of war facilities, a liberal construction of which might conceivably be sustained on a similar ground. None of the cases supports the view that the statute here involved is a relief provision to be liberally construed in favor of the taxpayer.

was not raised in either the petition before the Board or in the petition for review filed in the court below, and neither the Board nor the court below passed upon it. Petitioner raised the issue as an affirmative argument for the first time in a petition for rehearing filed in the court below which was denied.[10]

In any event, the argument is without merit. It is true that the Bureau of Internal Revenue has ruled that stock certificates issued prior to May 1, 1936, which contain an express provision restricting dividend payments, satisfy the requirements of Section 26 (c) (1) and that this ruling assumes that a stock certificate constitutes a written contract executed by the corporation. I. T. 3139, 1937—2 Cum. Bull. 111; I. T. 3152, 1938—1 Cum. Bull. 155. But, so far as the record shows, peti-

[10] Petitioner states in its brief (p. 5) that this point was urged before the court below "in brief and oral argument." Copies of petitioner's briefs in the court below are being filed with the Clerk of this Court. Petitioner's main brief contains no argument whatever with respect to its stock certificates; its reply brief (pp. 5–6) contains several oblique references to the stock certificates, made under the heading "The Charter Is a Written Contract Executed By the Corporation," and designed as a rebuttal to the Government's contention that a charter is not "executed" by the corporation. The recollection of counsel for the Government who handled the case below, with respect to the oral argument, is that counsel for petitioner started to discuss the issue by attempting to read one of petitioner's stock certificates to the court, but that after Government counsel objected that the stock certificate was not part of the record, no further argument on the point was made.

tioner's stock certificates, like its charter, contained no provision restricting dividend payments. The argument with respect to the stock certificates is, therefore, necessarily bottomed on the proposition, already shown to be untenable, that a state statute is "a provision of a written contract executed by the corporation" within the meaning of Section 26 (c) (1). By issuing its stock, petitioner certainly made no express agreement that its directors would not distribute dividends except in accordance with state law; at most, such an agreement is implied by law. As we have pointed out, this is not sufficient to satisfy the requirements of Section 26 (c) (1); the plain, obvious, and rational meaning of the words "a provision of a written contract" is a provision expressly written into a contract and not one that is implied. Moreover, the practical considerations and legislative history which militate against petitioner's position are equally cogent whether a stock certificate or a charter is relied upon as constituting the written contract. And reliance upon the stock certificates fails utterly to answer the persistent query why, if Congress had intended statutory restraints to entitle corporations to the credit, it failed to say so expressly.

We submit, therefore, that the North Dakota statute, whether considered in conjunction with petitioner's charter or in conjunction with its stock certificates, does not entitle petitioner to the credit provided for by Section 26 (c) (1).

II

THE UNDISTRIBUTED PROFITS TAX, AS APPLIED TO PETITIONER, DOES NOT VIOLATE THE FIFTH AMENDMENT

In its petition for certiorari, the only constitutional question raised by petitioner was whether, if it was not entitled to credit under Section 26 (c) (1), the undistributed profits tax, as applied to it, violated the Fifth Amendment because of arbitrary and unreasonable classification (Pet. 2, 10–11, 20–22). In its brief on the merits, however, petitioner seeks to raise additional questions (Br. 43–48) by contending (1) that a corporate income tax is an excise which the Constitution requires to be uniform and that the undistributed profits tax, as construed by the court below, does not operate with uniformity; (2) that the tax is invalid because it is a penalty tax; (3) that the tax is an illegal regulation of the internal affairs of corporations, which is a matter reserved to the states by the Tenth Amendment; and (4) that the tax is unconstitutional because it taxes corporations for not doing an unlawful and criminal act.[11] Because of petitioner's fail-

[11] In the court below, petitioner's only constitutional argument was that the statute was invalid because it imposed a tax for failure to do an unlawful and criminal act. This point was not raised in the petition for certiorari and is not available on this record, since the North Dakota statute (*infra*, pp. 58–60) imposes a civil and not a criminal liability on directors distributing dividends otherwise than from surplus profits of the business.

ure to raise these questions in its petition for certiorari, this Court is not required to pass on them (see *Gunning* v. *Cooley*, 281 U. S. 90; *Sonzinsky* v. *United States*, 300 U. S. 506; *Connecticut Ry. Co.* v. *Palmer*, 305 U. S. 493) and consequently we will not discuss them in this brief.[12]

In considering whether the tax, as applied to petitioner, violates the Fifth Amendment because of arbitrary and unreasonable classification, it is fundamental to note that the tax is imposed, not upon distributable undistributed profits, as petitioner suggests (Br. 6), but upon all undistributed profits, whether distributable or not, with the sole exception of the comparatively few situations to which Section 26 (c) apply. Consequently, the only two possible questions of classification which may be raised are: (1) whether Congress may properly draw a distinction between corporations having undistributed net income (whether or not such income is distributable) and corporations not having undistributed net income; and (2) whether,

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[12] For the same reason, we do not discuss a number of general questions as to the constitutionality of the undistributed profits tax raised by the brief of *amici curiae* filed in support of the petition for a writ of certiorari.

Several of those constitutional arguments were raised below by the respondent in *Helvering* v. *Northwest Steel Rolling Mills, Inc.*, now pending on petition for certiorari, No. 121, present Term. If certiorari is granted in the *Northwest Steel* case, the Government will discuss these contentions in its brief in that case.

if Congress may draw this distinction, it may, for cogent reasons of administrative convenience, grant a deduction or credit to corporations prohibited from distributing their income because of certain types of contractual restraints and deny such a deduction or credit to corporations prohibited from distributing their income by reason of other types of restraints.

1. There can, we believe, be no serious constitutional attack on the undistributed profits tax on the ground that it puts corporations which do not distribute their earnings in a different class from corporations which make such distributions. This classification represents the fundamental policy of the statute. Before its enactment into law, corporate income which was distributed was taxable to the stockholders, whereas corporate income which was undistributed escaped such taxation, even though the economic benefit to the stockholders, as beneficial owners of the business, was the same in each situation. This not only created an inequality in the tax burden imposed upon the earnings of different corporations but also provided a means for stockholders to avoid surtaxes on their individual incomes. Moreover, there was inequality in the tax upon the earnings of corporations and of unincorporated enterprises, such as partnerships, since partnership income was taxable to the partners whether distributed or not, whereas stockholders avoided tax on the undistributed earn-

ings of their corporations. It was to remove these inequalities and to eliminate the avoidance of surtaxes that the tax on undistributed profits was enacted. See H. Rep. No. 2475, 74th Cong., 2d Sess., pp. 1–3.[13]

The concept of a surtax on undistributed profits was by no means a new tax theory.[14] In every revenue act since 1921, a special tax had been imposed on corporations formed or availed of to prevent, through the accumulation of profits, the imposition of surtaxes on their shareholders.[15] Section 102 of the Revenue Act of 1934 (48 Stat. 702), the imme-

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[13] A very complete history of this legislation is to be found in an article entitled "Taxation of Undistributed Corporate Profits" by John B. Martin, Jr., 35 Mich. L. Rev. 44 (1936).

[14] See Report of the Secretary of the Treasury (1920), pp. 39–41. An amendment to the Revenue Act of 1924 embodying this principle was passed by the Senate. See 65 Cong. Rec. 8033. See also Report of Joint Committee on Internal Revenue Taxation (1927), Vol. 1, p. 54; 80 Cong. Rec. 9164. At the time of the enactment of the undistributed profits tax, Belgium and Norway had similar taxes. Belgium: Law of October 29, 1919, 1919 2 Pasinomie 169; Norway: Law of July 13, 1921, 1921 Norsk Lovtidende (2nen avdeling) 341. See Tax Systems of the World (1935) 334.

[15] 1921 Act, Section 220, 41 Stat. 247; 1924 Act, Section 220, 43 Stat. 277; 1926 Act, Section 220, 44 Stat. 34; 1928 Act, Section 104, 45 Stat. 814; 1932 Act, Section 104, 47 Stat. 195; 1934 Act, Section 102, 48 Stat. 702; 1936 Act, Section 102, 49 Stat. 1676. Prior to the 1921 Act, where corporate profits were accumulated for the purpose of preventing the imposition of surtaxes upon the stockholders, a separate tax was laid upon the stockholders. Tariff Act of 1913, Section II A (1), 38 Stat. 166; Revenue Act of 1916, Section 3, 39 Stat. 758; Revenue Act of 1918, Section 220, 40 Stat. 1072.

diate precursor of the undistributed profits tax, provided for the imposition of a graduated surtax upon the income of such corporations. But because of the difficulty of proving the interdicted purpose, this system of taxation presented serious administrative problems and was only partially effective. See H. Rep. No. 1860, 75th Cong., 3d Sess., pp. 2–3. In the Revenue Act of 1936, the provision for the imposition of a surtax on some classes of corporations improperly accumulating surplus was retained and strengthened (Section 102, 49 Stat. 1676), but by Section 14, the principle was extended to all corporations failing to distribute their income, regardless of the presence or absence of any motive of tax avoidance. By this extension, as above stated, Congress sought not only to prevent the avoidance of surtaxes, but, primarily, to provide a fairer distribution of the tax load among all the beneficial owners of business profits, whether derived from unincorporated enterprises or from incorporated businesses, and whether distributed or retained.

There can be no substantial doubt as to the constitutionality of this method of corporate income taxation, nor as to the validity of the classification of income as distributed or undistributed, which is its fundamental requisite. In *Helvering* v. *National Grocery Co.*, 304 U. S. 282, this Court upheld Section 104 of the Revenue Act of 1932 (47 Stat. 195) which, like Section 102 of the 1934 and

1936 Acts, put into a separate class corporations which were formed, or availed of, for the purpose of accumulating income and thereby preventing the imposition of surtaxes on their stockholders. The decision is closely in point, for the creation of a separate classification plainly does not depend for its validity on the existence of a tax evasion motive. Congress may, in its discretion, make any classification which is reasonably designed to afford an equitable distribution of the tax burden or which has reasonable relation to a legitimate end of governmental action. Cf. *Welch* v. *Henry,* 305 U. S. 134; *Watson* v. *State Comptroller,* 254 U. S. 122. The classification here under consideration, which is based on the theory that the corporate profits of a nondistributing corporation have not borne the same tax burden as the profits of a distributing corporation or those of a partnership, clearly meets this test.

2. Since Congress could validly distinguish for tax purposes between corporations distributing and those retaining their net earnings, the tax would clearly be valid if no deductions whatever were granted to corporations under either contractual or legal restraints against the payment of dividends. There remains, therefore, only the question whether the allowance of a credit to nondistributing corporations which are under certain types of contractual restraint against the payment of dividends unlawfully discriminates against corpora-

tions, like petitioner, which are under other types of restraint.

The answer to this question is not in doubt. The allowance of deductions and credits is a matter of legislative grace. *Helvering* v. *Inter-Mountain Life Insurance Co.*, 294 U. S. 686; *Helvering* v. *Ind. Life Ins. Co.*, 292 U. S. 371; *New Colonial Ice Co.* v. *Helvering*, 292 U. S. 435; *White* v. *United States*, 305 U. S. 281; *Deputy* v. *duPont*, 308 U. S. 488. This being so, it is difficult to conceive of any state of facts in which it could successfully be maintained that in granting one deduction and failing to grant another Congress had violated the due process clause because of arbitrary classification. Each time the argument has been made it has been rejected. *Brushaber* v. *Union Pacific R. R. Co.*, 240 U. S. 1; *Anderson* v. *Forty-two Broadway Co.*, 239 U. S. 69; *Denman* v. *Slayton*, 282 U. S. 514; cf. *Welch* v. *Henry*, 305 U. S. 134.

But even if a denial of one deduction or credit and the allowance of another might in some instances result in a denial of due process, yet in this case there was clearly a rational basis for the distinction which Congress drew. It is, in the normal case, a comparatively easy matter for the Bureau of Internal Revenue to ascertain whether a corporation has executed a written contract which expressly prohibits it from paying dividends. But, as we have suggested above, it would impose an intolerable administrative burden on the Bureau

if it were required to determine whether a corporation was prevented from distributing its earnings by virtue of state law. That would involve not only examination of the statutes of the various states and of the decisions construing them, but also an analysis of the entire financial history of each corporation claiming the credit. See Note (1936) 83 U. of Pa. L. Rev. 91–92. The discussion in the succeeding section of this brief of whether the taxpayer in this case was prohibited by North Dakota law from distributing its earnings furnishes a striking illustration of the difficulties involved.

It is no answer for petitioner to suggest (Br. 43–44) that the same difficulties might be encountered had the corporation expressly written into its stock certificates the provisions of state law. It is a matter of common knowledge that the provisions of state regulatory statutes are not normally written into stock certificates and Congress must be presumed to have legislated with this fact in mind. In the usual case of a contractual restraint no difficulties of interpretation are presented and no analysis of the financial situation of the corporation is required in order to determine whether the restraint is operative. The fact that in certain unusual cases which may be conceived of, the Bureau might have the same difficulty in determining whether a corporation was under a contractual restraint as it would normally have in determining whether the corporation was under a statutory

restraint, does not make unreasonable the distinction drawn by Congress between these two situations.

This Court has recognized that the income tax laws do not profess to embody perfect economic theory (*Helvering* v. *Midland Mutual Life Ins. Co.*, 300 U. S. 216) and that they must sometimes yield to the exigencies of administration. See *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359; *Woolford Realty Co.* v. *Rose*, 286 U. S. 319. Pragmatic reasons of administrative convenience, such as those here involved, are alone sufficient justification for the difference between the treatment of corporations under express contractual restraint against the payment of dividends and corporations under a similar statutory restraint. *Carmichael* v. *Southern Coal Co.*, 301 U. S. 495; *Steward Machine Co.* v. *Davis*, 301 U. S. 548.

It has been repeatedly held that a wide discretion must be conceded to the legislative power in the matter of classification. *Flint* v. *Stone Tracy Co.*, 220 U. S. 107; *Tax Commissioners* v. *Jackson*, 283 U. S. 527; *Magoun* v. *Illinois Trust & Savings Bank*, 170 U S. 283. The differences between the class which is taxed and that which is not need not be great; the classification will be upheld if any state of facts can reasonably be conceived to sustain it. *Tax Commissioners* v. *Jackson, supra; Rast* v. *Van Deman & Lewis*, 240 U. S. 342; *Metropolitan Casualty Ins. Co.* v. *Brownell*, 294 U. S. 580; *Carmichael* v. *Southern Coal Co.*,

supra; Madden v. *Kentucky,* 309 U. S. 83. Here the reason for the difference in treatment of statutory restraints and of express contractual restraints is both apparent and cogent; under established authorities it precludes successful attack under the Fifth Amendment.[16]

III

PETITIONER HAS NOT SUSTAINED THE BURDEN OF PROVING THAT IT WAS PROHIBITED BY NORTH DAKOTA LAW FROM DISTRIBUTING ITS 1936 EARNINGS AS DIVIDENDS

For purposes of the discussion under Points I and II, we have assumed, *arguendo,* that the North Dakota statutes prohibited petitioner's directors from distributing as dividends any portion of the company's adjusted net income for 1936. However, should the Court reject the contentions advanced under these points, further inquiry would be required as to whether petitioner has sustained the burden of proving that it was in fact prohibited by state law from distributing all or any part of its net earnings. In our view, this burden has not been met.[17]

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[16] Petitioner cites *Prudential Tobacco Co.* v. *Commissioner,* 42 B. T. A. No. 80, as indicating that the Board of Tax Appeals entertains doubts as to the constitutional issue here presented (Br. pp. 13, 45). The doubts there expressed by the Board relate only to the validity of making the undistributed profits tax retroactive to a short period ending before the Act was approved.

[17] Neither the Board nor the court below found it necessary to pass upon this point, although it was presented to both.

Petitioner's net income for 1936 was $13,450.76 and its adjusted net income was $12,032.72. It was stipulated before the Board that as of January 1, 1936, petitioner had a deficit of at least $21,251.40 (R. 12), but that the records prior to January 1, 1929, were not susceptible of analysis to show definitely whether this deficit occurred from operating losses or capital distributions in excess of earnings or was effected by other adjustments (R. 12). It was further stipulated that no dividend distributions had been made by the petitioner since March 1930, when $9,672 was distributed from then existing surplus (R. 12).

Section 4543 of the North Dakota Laws provides as follows:

> *Dividends only from profits; limitations of indebtedness; exceptions.*—The directors of corporations must not make dividends except from the surplus profits arising from the business thereof; nor must they divide, withdraw or pay to the stockholders, or any of them, any part of the capital stock, nor must they create debts beyond the subscribed capital stock, or reduce or increase the capital stock, except as specially provided by law; * * *.

The question which arises under this statute, as applied to the present case, is whether the stipulation that the corporation had a "deficit" as of January 1, 1936, of a greater amount than its net earnings for 1936 constitutes a showing that the

corporation had no "surplus profits" from which dividends could be paid during that year.[18]

There are no North Dakota decisions which illuminate the meaning of the statutory phrase "surplus profits".[19] Several decisions of other

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[18] It seems clear that a distribution of the petitioner's net income for 1936 would not have constituted a division of capital stock between the stockholders within the meaning of Section 4543. The deficit already existed and would not have been increased or diminished by such a distribution.

[19] In *Lark Equity Exchange* v. *Jones*, 42 N. D. 145, the corporation sued a stockholder to recover dividends alleged to have been paid while there was a deficit. The complaint alleged that on the basis of a financial statement prepared by the manager the directors had declared a dividend; that the statement was erroneous; that the corporation in fact had no profits; that after discovering the error the directors rescinded the resolution declaring the dividend and ordered the money paid back; and that the defendant, who was one of the stockholders, had refused to return the amount received. Recovery was denied on the ground that the evidence failed to disclose the financial condition of the corporation at the time the dividend was declared.

In *Ulness* v. *Dunnell*, 61 N. D. 95, a trustee in bankruptcy sued the stockholders of a corporation to recover dividends the payment of which had rendered the corporation insolvent. The facts disclosed that the corporation's assets consisted chiefly of patents which it had sold to a Canadian corporation and that the distribution had been made from the proceeds of the sale. The distribution left the corporation with debts of $15,000 and assets of only $500. The court stated that under North Dakota statutes dividends could not be paid except out of profits of the corporation and that the stockholders had no right to retain dividends paid out of the capital stock of an insolvent corporation. It implied that recovery might have been denied if the corporation had been solvent and the stockholders had received the dividend in good faith.

courts, however, indicate the view that the phrase should be construed as meaning an excess of gains over expenditures; under definitions of this character, it is arguable that distributions can be made from current net earnings even though a capital deficit exists. *Southern Cal. Home Builders* v. *Young,* 45 Cal. App. 679; *Excelsior Water & Mining Co.* v. *Pierce,* 90 Cal. 131; cf. *Goodnow* v. *American Writing Paper Co.,* 73 N. J. Eq. 692; *Borg* v. *International Silver Co.,* 11 F. (2d) 147 (C. C. A. 2d).[20] If the North Dakota statute be thus interpreted, it is apparent that petitioner was under no legal restraint against the distribution of its 1936 earnings.

It is true, however, that the great weight of authority is to the effect that a statutory prohibition against the payment of dividends except from "surplus," "surplus profits," or "net profits" prevents the payment of dividends from current earnings so long as a capital deficit exists. See Ballantine and Hills, *Corporate Capital and Restrictions on Dividends Under Modern Corporation Laws* (1935) 23 Cal. L. Rev. 229, 238, *et seq;*

[20] The English "Companies Acts" have been construed as not requiring that a capital deficit be made up before dividends may be paid from annual profits. *Lee* v. *Neuchatel Asphalte Co.* [1889], 41 Ch. 1; *Ammonia Soda Co.* v. *Chamberlin* [1918], 1 Ch. 266; 9 B. R. C. 819. The English cases are discussed in "Theory of Anglo-American Dividend Law", by Weiner, 28 Col. L. Rev. 1046; in 55 A. L. R. 8, 20–22; and in "Corporate Capital and Restrictions Upon Dividends under Modern Corporation Laws", by Ballantine and Hills, 23 Cal. L. Rev. 229, 252–255 (1935).

Wiener, *Theory of Anglo-American Dividend Law* (1929) 29 Col. L. Rev. 461, 462 *et seq.* In the states where this rule prevails, the term "surplus," "surplus profits," or "net profits" have been interpreted as meaning the amount by which the present value of a corporation's assets exceeds its liabilities, including capital stock, or as the amount of accumulated profit above expenses and past operating losses. See, e. g., *Williams* v. *Western Union Telegraph Co.*, 93 N. Y. 162; *Russell* v. *Bristol*, 49 Conn. 251; *Crawford* v. *Roney*, 130 Ga. 515; *Coleman* v. *Booth*, 268 Mo. 64; *Splittgerber Bros.* v. *Skinner Packing Co.*, 119 Neb. 259; *Park* v. *Grant Locomotive Works*, 40 N. J. Eq. 114, affirmed, 45 N. J. Eq. 244; *Branch* v. *Kaiser*, 291 Pa. 543; Fletcher, *Cyclopedia of Corporations* (Permanent Ed.) Vol. 11, Sec. 5335; Thompson, *Corporations* (3rd Ed.) Vol 7, Secs. 5292, 5293.

Petitioner has not proved that it was prohibited from paying dividends in 1936 under this test. The only evidence upon which it can rely is (1) the stipulated fact that it had a "deficit" of at least $21,251.40 on January 1, 1936 (R. 12); and (2) its balance sheet, showing a deficit on that date of $22,876.40 (R. 7). It is clear that neither the stipulation, which was based on the book figure,[21] nor

[21] The discrepancy between the stipulated "deficit" of $21,251.40 and the balance sheet "deficit" of $22,876.40 arises from the fact that an audit of the books for 1935 made by a firm of certified public accountants resulted in a reduction of $1,625 in the value at which treasury stock was carried on the books of the company (R. 12).

the book figure itself, constitutes proof that the value of the corporation's assets was less than the amount of its liabilities, including capital stock. There is no showing whatever in the record that the book value placed upon the assets represented actual value, there is no showing of how the book value was computed, and there is no showing of what the actual value of the assets was. There is also no showing of how the amount taken for depreciation, which was more than 33⅓% of the book value of the depreciable assets (R. 7), was arrived at. Clearly this Court cannot assume that petitioner had no surplus profits (construing that term to mean the excess of the value of its assets over the sum of its liabilities, including legal capital) simply because its books showed a deficit.

Nor can petitioner show that it had no accumulated profits above expenses and past operating losses. There is no proof whatever of the net earnings or losses of the company for any year prior to 1936, and it is stipulated that the records of the company prior to January 1, 1929, are not susceptible of analysis to show definitely whether the "deficit" as of January 1, 1936, occurred from operating losses or capital distributions in excess of earnings or was effected by other adjustments.[22]

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[22] While it is true that the stipulation recites that petitioner had a surplus in 1930 and that it has distributed no dividends since 1930, it is not at all clear whether the stipu-

Consequently, petitioner did not and could not establish that it had no accumulated profits in 1936 from which it could have distributed dividends.

There can be no question that the burden of proof was upon petitioner to show that it was prohibited by state law from paying out dividends in 1936. See *Helvering* v. *Leonard*, 310 U. S. 80, 86; *Helvering* v. *Fitch*, 309 U. S. 149. Petitioner having failed to furnish the requisite proof, neither the Commissioner nor the courts are called upon to conjecture as to what the actual situation in 1936 may have been.

CONCLUSION

The decision of the court below should be affirmed on the ground that the North Dakota statute prohibiting dividends except from surplus profits is not a provision of a written contract executed by the petitioner within the meaning of Section 26 (c) (1) and that the statute, so construed, is constitutional. But if the Court should hold otherwise, the decision of the court below should be affirmed on the ground that the petitioner has not sustained the burden of proving that the distribu-

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lation refers to accumulated profits or to the excess of the value of the company's assets over its liabilities, including capital stock, and, if the latter, whether the assets were taken at book value or at actual value. Petitioner's balance sheet for 1930 was not introduced in evidence and no proof was offered as to the financial situation of the company at that time.

tion of its adjusted net income for 1936 would have constituted a violation of state law.

Respectfully submitted.

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SEPTEMBER 1940.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) *Definitions.*—As used in this title—

(1) The term "adjusted net income" means the net income minus the sum of—

(A) The normal tax imposed by section 13.

(B) The credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

* * * * *

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

12 per centum of the portion of the undistributed net income which is in excess of 10 per centum and not in excess of 20 per centum of the adjusted net income.

17 per centum of the portion of the undistributed net income which is in excess of

20 per centum and not in excess of 40 per centum of the adjusted net income.

22 per centum of the portion of the undistributed net income which is in excess of 40 per centum and not in excess of 60 per centum of the adjusted net income.

27 per centum of the portion of the undistributed net income which is in excess of 60 per centum of the adjusted net income.

(c) *Adjusted Net Income Less Than $50,000.*—

(1) *Specific Credit.*—If the adjusted net income is less than $50,000, there shall be allowed a specific credit equal to the portion of the undistributed net income which is in excess of 10 per centum of the adjusted net income and not in excess of $5,000, such credit to be applied as provided in paragraph (2).

(2) *Application of Specific Credit.*—If the corporation is entitled to a specific credit, the tax shall be equal to the sum of the following:

(A) A tax computed under subsection (b) upon the amount of the undistributed net income reduced by the amount of the specific credit, plus

(B) 7 per centum of the amount of the specific credit.

* * * * *

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * *

(c) *Contracts Restricting Payment of Dividends.*—

(1) *Prohibition on Payment of Dividends.*—An amount equal to the excess of

the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

(2) *Disposition of Profits of Taxable Year.*—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

(3) *Double Credit Not Allowed.*—If both paragraph (1) and paragraph (2) apply, the one of such paragraphs which allows the greater credit shall be applied; and, if the credit allowable under each paragraph is the

same, only one of such paragraphs shall be applied.

* * * * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made

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[U. S. C. Supp. V, Title 26, Sec. 115.]

North Dakota Compiled Laws—Supplement—(Annotated), 1913–1925:

SEC. 4543. *Dividends only from profits; limitations of indebtedness; exceptions.*—The directors of corporations must not make dividends except from the surplus profits arising from the business thereof; nor must they divide, withdraw or pay to the stockholders, or any of them, any part of the capital stock, nor must they create debts beyond the subscribed capital stock, or reduce or increase the capital stock, except as specially provided by law; provided, however, that the above limitation as to the creation of debts shall not apply to the policy risks of insurance companies on which no loss has oc-

curred, or the notes, bonds or debentures of any loan or trust company, or public utility, company or corporation, organized under the provisions of this chapter, when payment of such notes, bonds or debentures shall be secured by the actual transfer of real estate by trust deed or mortgage for the payment of such notes, bonds or debentures, which said real estate so transferred shall be of twice the value of the par value of such notes, bonds and debentures; provided further that the limitation as to the value of property conveyed by trust deed or mortgage shall not apply to the bonds or debentures of public utility corporations; provided, further, that such limitation shall not apply to any loan or trust company's guarantee of payment after transfer of any note, bond or debenture when the same is secured by trust deed or mortgage as above stated; provided, further that the above limitation as to the creation of debts shall not apply to certificates and debentures issued by investment companies for the creation of an investment fund where the holder of such certificates or debentures shall by the terms of the same, participate in the earnings of such investment fund. [Laws 1925, ch. 109, § 1.]

SEC. 4543a. *To what corporations applicable.*—The provisions of this act shall apply to corporations heretofore and hereafter organized. [Laws 1925, ch. 109, § 2.]

SEC. 4544. *Penalty for violation of statute.*—For a violation of the provisions of the last section [§ 4543] the directors under whose administration the same may have happened, except those who may have caused their dissent therefrom to be entered at large on the minutes of the directors at the time,

or were not present when the same did happen, are in their individual and private capacity, jointly and severally liable to the corporation, and to the creditors thereof, in the event of its dissolution, to the full amount of the capital stock so divided, withdrawn, paid out, or reduced, or debt contracted. There may, however, be a division and distribution of the capital stock of any corporation which remained after the payment of all its debts, upon its dissolution or the expiration of its terms of existence. No action or proceeding to enforce or recover any penalty, forfeiture or liability hereunder shall be commenced more than six months after the aggrieved party shall have had actual notice of the violation of the preceding section [§ 4543]. [Laws 1919, ch. 100, § 1.]

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 26–2. *Credit in connection with contracts restricting payment of dividends.*— (a) The credit provided in section 26 (c) with respect to contracts restricting the payment of dividends is not available under every contract which might operate to restrict the payment of dividends, but only with respect to those provisions of written contracts executed by the corporation prior to May 1, 1936, which satisfy the conditions prescribed in the Act. The charter of a corporation does not constitute a written contract executed by the corporation within the meaning of section 26 (c). The provisions recognized by the Act are of two general types, as follows:

(1) Those which come within section 26 (c) (1), in that they prohibit or limit

the payment of dividends during the taxable year; and

(2) Those which come within section 26 (c) (2), in that they require the payment, or irrevocable setting aside, within the taxable year, of a specified portion of the earnings or profits of the taxable year for the discharge of a debt incurred on or before April 30, 1936.

If a corporation is restricted with respect to the payment of dividends by two or more contract provisions coming within section 26 (c) (1), only the largest of the credits computed with respect to each of such provisions, and not their sum, shall be allowable under section 26 (c) (1) and, for such purpose, if two or more credits are equal in amount, only one shall be taken into account. However, section 26 (c) (3) provides that if both section 26 (c) (1) and section 26 (c) (2) apply, only the one of such paragraphs which allows the greater credit shall be applied, and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

(b) *Prohibition on payment of dividends.*—The credit provided in section 26 (c) (1) is allowable only with respect to a written contract executed by the corporation prior to May 1, 1936, which expressly deals with the payment of dividends and operates as a legal restriction upon the corporation as to the amounts which it can distribute within the taxable year as dividends. If an amount can be distributed within the taxable year as a dividend—

(1) in one form (as, for example, in stock or bonds of the corporation) without violating the provisions of a contract, but cannot be distributed within the taxable year as a

dividend in another form (as, for example, in cash) without violating such provisions, or

(2) at one time (as, for example, during the last half of the taxable year) without violating the provisions of a contract, but cannot be distributed as a dividend at another time within the taxable year (as, for example, during the first half of the taxable year) without violating such provisions—

then the amount is one which, under section 26 (c) (1) can be distributed within the taxable year as a dividend without violating such provisions.

The credit provided in section 26 (c) (1) is equal to the excess of the adjusted net income, as defined in section 14 (a), over the aggregate of the amounts which can be distributed within the taxable year without violating the provisions of such contract. The requirement that the provisions of the contract expressly deal with the payment of dividends is not met in case (1) a corporation is merely required to set aside periodically a sum to retire its bonds, or (2) the contract merely provides that while its bonds are outstanding the current assets shall not be reduced below a specified amount.

The computation of the credit allowable under section 26 (c) (1) may be illustrated by the following examples:

* * * * *

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